Luxembourg, 20 June 2013

ESM direct bank recapitalisation instrument

-Main features of the operational framework and way forward -

Following the 29 June 2012 statement by the Heads of State or Government of the euro area reaffirming the need to break the vicious loop between banks and sovereigns, the Eurogroup has worked intensively on the operational framework of the future ESM direct recapitalisation instrument. The main features of the instrument are now agreed in view of having the instrument operational once an effective Single Supervisory Mechanism is established.

Moreover, in December 2012, the European Council agreed to a more integrated financial framework in the European Union, where the key building blocks of the Banking Union would consist of the Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and of the possibility to use the ESM to recapitalise banks directly. In this context, the issue of legacy assets has also been addressed.

In order to reflect the close interrelation between the various components of the Banking Union legislation, most importantly the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Scheme Directive (DGSD), it is proposed that the operational framework, including the guideline, of the ESM direct recapitalisation instrument will be finalised as soon as the abovementioned legislative proposals have been finalised with the European Parliament. After finalisation of the operational framework and following the necessary national procedures, the ESM Board of Governors will add this new instrument to the list of ESM financial assistance instruments, in accordance with Article 19 of the ESM Treaty, via resolution, taken by mutual agreement. Decisions to grant ESM assistance through direct recapitalisation will also be taken by mutual agreement.

The following main features have been agreed by the Eurogroup and will thus be reflected in the operational framework of the instrument, when adopted:

Objective of the instrument

The objective of an ESM direct recapitalisation shall be to preserve the financial stability of the euro area as a whole and of its Member States in line with Article 3 of the ESM Treaty, and to help remove the risk of contagion from the financial sector to the sovereign by allowing the recapitalisation of institutions directly.

Eligibility criteria for the ESM Member and for the financial institution

The ESM may – on the request of an ESM Member and in accordance with the provisions of the ESM Treaty – conduct direct recapitalisations of an institution only if the following criteria are met:

(i) The requesting ESM Member is unable to provide financial assistance to the institutions in full without very adverse effects on its own fiscal sustainability. The use of this instrument can also be considered if it is established that other alternatives would have the effect of endangering the continuous market access of the requesting ESM Member and consequently require financing of the sovereign needs via the ESM.

(ii) Providing financial assistance to the requesting ESM Member is indispensable to safeguard the financial stability of the euro area as a whole or of its Member States.

(iii) The institution is (or is likely to be in the near future) in breach of the capital requirements established by the ECB in its capacity as supervisor and is unable to attract sufficient capital from private sources or other means in order to resolve its capital problems.

(iv) The institution has a systemic relevance or poses a serious threat to the financial stability of the euro area as a whole or the requesting ESM Member.

To ensure the most efficient use of ESM resources, the ESM will assist to directly recapitalise only those institutions whose viability can be secured through a capital injection and restructuring plan. The decision of the Commission approving the assistance and setting out the State aid conditionality is a prerequisite for the disbursement of financial assistance in the form of direct recapitalisation.

Limit

With a view to preserving the ESM´s lending capacity for other instruments, the ESM Board of Governors will establish an ex ante limit for the amount of financial assistance available for direct recapitalisation instrument in order to provide transparency for investors and help preserve the high creditworthiness of the ESM. The rationale behind establishing such a limit is to strike a balance between necessary containment of risks for the ESM and at the same time ensuring sufficient capacity for the instrument. Consequently, the limit will be set in the amount of EUR 60 billion, but can be reviewed by the Board of Governors, if deemed necessary.

Financial architecture of the instrument

For the purpose of conducting direct recapitalisations, the ESM will establish a fully owned subsidiary to allow sufficient flexibility and greater transparency in the recapitalisation operations, fully respecting the provisions of the ESM Treaty, including the decision-making powers of the ESM governing bodies and the limitation of liabilities of ESM Members. The ESM Boards may then decide to establish further subsidiary structures under the subsidiary to enhance risk transparency for investors and enable risk-taking on a country- or individual-institution basis, thereby fostering external and private capital investment alongside the ESM, in order to maximise the overall effectiveness of the instrument.

A robust valuation

Before any final decision to grant financial assistance and capital injection, a thorough due diligence and rigorous economic valuation, based on a sufficiently prudent scenario of a stress test, of the institution's assets is conducted. In addition, this valuation will identify the institution's loss absorption capacity as well as assess the institution's viability. The valuation is based on the real economic values of the institutions' assets as determined by observable market inputs when possible and realistic and prudent assumptions of future cash flows. As a rule this will be done with the support of external experts, under the guidance of the ESM, in liaison with the ECB in its capacity as supervisor and the European Commission. The ECB in its capacity as supervisor will set the appropriate capital requirement.

Appropriate burden sharing structure

There will be a clear pecking order for recapitalisation operations as described above and private capital resources will be explored as a first solution, including sufficient contributions from existing shareholders and creditors of the beneficiary institution(s). An appropriate level of write-down or conversion of debt will have to take place in line with EU State aid rules, and applying the principles of the forthcoming Bank Recovery and Resolution Directive as of the start of the supervision of the ECB/SSM.

In addition, a burden-sharing scheme will determine the contributions of the requesting ESM Member and the ESM, respectively. This scheme will comprise two parts:

First part: if, upon conducting the robust valuation explained above, (one of) the beneficiary institution(s) has insufficient equity to reach the legal minimum Common Equity Tier 1 (CET1) ratio of 4.5%, as established in the Basel III framework/CRD IV/CRR, under a sufficiently prudent scenario of a stress test, the requesting ESM Member will be required to make a capital-injection to reach this level before the ESM enters into the capital of the institution.

Second part: if (one of) the institution(s) already meets the above-mentioned capital ratio, the requesting ESM Member will be required to make a capital contribution alongside the ESM, equivalent to 20% of the total amount of the public contribution in the first two years after the entry into force of the instrument and to 10% afterwards.

If the contribution in this first part is lower than would have been required in the second part, the requesting ESM Member would be asked to inject an additional amount alongside the ESM to cover the difference.

The scheme also leaves flexibility to the Board of Governors to partially or fully suspend such contribution by mutual agreement in those exceptional cases in which the ESM Member is not able to contribute up-front due to its fiscal position and significant implications for its market access. This burden sharing between the ESM and the requesting ESM Member is specifically constructed in a way to cater for the existence of legacy assets, through the first part of the scheme, as well as for the need to ensure that incentives are always properly aligned through the second part.

The total capital injected by both the ESM and the ESM Member shall be of the amount required to reach the necessary capital level as determined by the supervisor, taking into account the possible participation of external private investors.

Capital instruments

As a general rule, recapitalisation by the ESM should be conducted against the acquisition of common equity shares that satisfy the Common Equity Tier 1 capital requirements of the Capital Requirements Regulation.

Conditionality

In line with Article 12 of the ESM Treaty, the use of the instrument will always be linked to appropriate conditionality. In addition to the institution-specific conditionality established under State-aid rules, the ESM, in liaison with the Commission and the ECB, shall establish additional institution-specific conditions, including, where appropriate, rules on the remuneration of management and bonuses. Other policy conditions, including where appropriate those related to the general economic policies of the ESM Member concerned, are included in the MoU attached to the financial assistance. All conditionality shall be closely monitored.

Governance and exercising a stewardship role

It is imperative that the ESM safeguards its resources and thus has a say in not only the subsidiary that will be established for the conduct of direct recapitalisation but also the beneficiary institution(s) concerned. The ESM will exert an appropriate influence, commensurate to its exposure, both through its role as a shareholder and through the conditions imposed within the recapitalisation operation.

The subsidiary will not, except for purely administrative purposes, have own decision-making powers as the decisions relevant for the purpose of the direct recapitalisation operation will be taken by the respective governing bodies of the ESM.

Issues such as the degree of involvement in determining and approving strategy and business models, monitoring business performance, appointing senior management, appointing board members, and exercising voting rights have to be addressed by the ESM for each beneficiary institution.

In order to ensure a return to market functioning and secure a beneficiary institution's viability, a careful balancing between influence by the ESM and the maintenance of independent commercial business practices will be required. Such considerations also have a direct impact on the potential application of the EU Merger Regulation.

The ESM Board of Governors and Board of Directors will receive all information relevant to fulfill their tasks and obligations.

Evolution of the instrument over time

The establishment of the Single Supervisory Mechanism will gradually shift supervisory and some macroprudential responsibilities to the European level and ensure homogeneous supervisory treatment of banks across ESM Members. Consequently, the instrument guideline will have to be reviewed at least every two years after its entry into force, including the burden sharing scheme, in order to take into account the progress of the Banking Union and any relevant banking sector legislation as well as the temporary nature of legacy assets.

Potential retroactive application

The potential retroactive application of the instrument should be decided on a case-by-case basis and by mutual agreement.